

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
BRIEF**

77-4143

To be argued by
BURTON G. LIPSKY

In The
United States Court of Appeals
For The Second Circuit

MIRIAM SAKOL,
Petitioner-Appellant,

-against

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Review of Decision of the United States Tax Court.

BRIEF FOR PETITIONER-APPELLANT

BURTON G. LIPSKY
Attorney for Petitioner-Appellant
230 Park Avenue
New York, New York 10017
(212) 661-9800

Of Counsel:
DELSON & GORDON

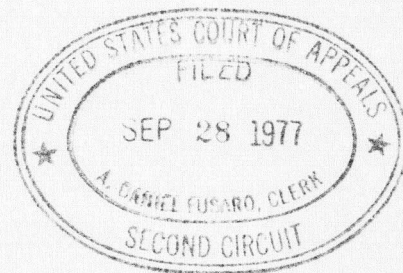


TABLE OF CONTENTS

	<u>Page</u>
JURISDICTION	1
STATEMENT OF THE ISSUE PRESENTED FOR REVIEW	2
STATEMENT OF THE CASE	2
A. STATEMENT OF PROCEEDINGS	2
B. STATEMENT OF FACTS	3
SUMMARY OF ARGUMENT	5
ARGUMENT	6
 I SECTION 83 OF THE CODE IS A SIGNIFICANT DEPARTURE FROM THE BASIC CONCEPT OF INCOME TAXATION THAT THE MEASURE OF AN EMPLOYEE'S INCOME ON A BARGAIN PURCHASE OF PROPERTY CANNOT EXCEED THE ACTUAL FAIR MARKET VALUE OF SUCH PROPERTY	6
 II SECTION 83(a) IS UNCONSTITUTIONAL TO THE EXTENT IT REQUIRES PETITIONER TO PAY INCOME TAX BASED ON A LEGISLATIVELY MANDATED VALUATION OF PROPERTY WHICH ARBITRARILY EXCEEDS THE ACTUAL FAIR MARKET VALUE OF THE PROPERTY RECEIVED	13
A. Section 83(a) as Applied to Petitioner is Unconstitutional under the Fifth Amendment	15
B. Section 83(a) as Applied to Petitioner is Unconstitutional under the Sixteenth Amendment	25

TABLE OF AUTHORITIES

	<u>Page</u>
<u>UNITED STATES CONSTITUTION</u>	
U.S. CONST. Art. I, §2	14
U.S. CONST. Art. I, §8	13
U.S. CONST. Art. I, §9	14
U.S. CONST. Amend. V	2, 5, 14-17
U.S. CONST. Amend. XIV	16
U.S. CONST. Amend. XVI	2, 5, 14, 25, 26-28
<u>STATUTES</u>	
Int. Rev. Code of 1954, §83	2, 4-7, 10-21, 24-28
Int. Rev. Code of 1954, §402(b)	11
Revenue Act of 1926, §302(c)	15
<u>CASES</u>	
<u>Belcher, Richardson v.</u> , 404 U.S. 788 (1971)	23
<u>Burk-Waggoner Oil Ass'n v. Hopkins</u> , 269 U.S. 110 (1925)	27
<u>Burnet v. Wells</u> , 289 U.S. 670 (1933)	17-18
<u>City Bank Farmers Trust Co., Helvering v.</u> , 296 U.S. 85 (1935)	20
<u>Cleveland Bd. of Educ. v. LaFleur</u> , 414 U.S. 632 (1974) .	22-24
<u>Donnan, Heiner v.</u> , 285 U.S. 312 (1932)	15-17, 20, 24, 25

	<u>Page</u>
<u>Eisner v. Macomber</u> , 252 U.S. 189 (1920)	25
<u>Geeseman, Delbert G.</u> , 38 B.T.A. 258 (1938)	8
<u>Hoeper v. Tax Commission</u> , 284 U.S. 206 (1931)	15, 17, 20, 24, 27
<u>Kalech, Phil</u> , 23 T.C. 672 (1955)	8
<u>Kuchman, Harold H.</u> , 18 T.C. 154 (1954)	8
<u>LoBue, Commissioner v.</u> , 351 U.S. 243 (1956)	8
<u>MacDonald v. Commissioner</u> , 230 F.2d 534 (7th Cir. 1956) and 248 F.2d 552 (7th Cir. 1957)	8
<u>Miller v. Carter</u> , 547 F.2d 1314 (7th Cir. 1977)	22
<u>Murry, U.S. Dep't of Agriculture v.</u> , 413 U.S. 508 (1973)	22, 23
<u>Nestor, Flemming v.</u> , 363 U.S. 603 (1960)	23
<u>Nicol v. Ames</u> , 173 U.S. 509 (1899)	19
<u>Ogsbury, Estate of, Commissioner v.</u> , 258 F.2d 294 (2d Cir. 1958)	8
<u>Salfi, Weinberger v.</u> , 422 U.S. 749 (1975)	22
<u>Schlesinger v. Wisconsin</u> , 270 U.S. 230 (1926)	15-16, 20, 24
<u>Smith, Commissioner v.</u> , 324 U.S. 117 (1945)	8
<u>Steward Machine Co. v. Davis</u> , 301 U.S. 548 (1937)	15
<u>Stanley v. Illinois</u> , 405 U.S. 645 (1972)	21-22, 24
<u>Stuart, Helvering v.</u> , 317 U.S. 154 (1942)	26
<u>Victorson v. Commissioner</u> , 326 F.2d 264 (2d Cir. 1964) .	8
<u>Vlandis v. Kline</u> , 412 U.S. 441 (1973)	20, 23, 24

	<u>Page</u>
<u>TREASURY REGULATION PROVISIONS</u>	
Treas. Reg. §1.61-2(d) (1959)	8-9
Treas. Reg. §1.421-6 (1959)	8-9
Treas. Reg. 65, Art. 31, §213(a) (1924)	8
Treas. Reg. 111, §29.22(a)-1 (1943, 1946)	8
Proposed Treas. Reg. §1.61-2(d), 33 Fed. Reg. 15870 (1968)	9
Proposed Treas. Reg. §1.421-6, 21 Fed. Reg. 8774 (1956)	8
Proposed Treas. Reg. §1.421-6(d), 33 Fed. Reg. 15870 (1968)	9

MISCELLANEOUS

<u>Hearings on the Subject of Tax Reform before the</u> <u>House Committee on Ways and Means, 91st Cong.,</u> <u>1st Sess. 5498 (1969)</u>	10
H. Rep. No. 91-413 (part 2), 91st Cong., 1st Sess. 62 (1969)	18, 25
Rev. Rul. 68-86, 1968-1 C.B. 184	4, 9, 25
S. Rep. No. 91-552, 91st Cong., 1st Sess. 124 (1969), 1969-3 C.B. 500	20
Treas. Dec. 3485, II-1 C.B. 50 (1923)	8

IN THE
UNITED STATES COURT OF APPEALS
For the Second Circuit
No. 77-4143

MIRIAM SAKOL,

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

Review of Decision of the United States Tax Court

BRIEF OF PETITIONER-APPELLANT

JURISDICTION

Jurisdiction of the appeal of Miriam Sakol is in this Court under Section 7482(a) of the Internal Revenue Code. The venue of the appeal is in this Court under Section 7482(b)(1)(A) of the Code.

STATEMENT OF THE ISSUE PRESENTED FOR REVIEW

Whether the Tax Court erred in holding that Section 83(a) of the Internal Revenue Code is constitutional, even though it mandates a valuation of property which ignores a restriction which substantially affects the actual fair market value of the property and, therefore, requires petitioner to pay income tax on value never received.

STATEMENT OF THE CASE

A. Statement of Proceedings

The sole issue before the Tax Court was the constitutionality of Section 83(a) of the Internal Revenue Code. The petitioner contended before the Tax Court that Section 83(a) is unconstitutional to the extent it compels petitioner to pay income tax based upon the receipt of property in excess of its fair market value on the date of the taxable event.

The Tax Court filed its opinion (56a-72a)^{1/} -- which was not reviewed by the full Court -- on March 23, 1977, holding Section 83(a) not unconstitutional under the Fifth and Sixteenth Amendments.

^{1/} Page numbers are references to the Appendix.

The decision of the Tax Court (73a) was entered on June 29, 1977. Notice of Appeal was filed by petitioner on July 20, 1977 (75a).

B. Statement of Facts

During 1971 and 1972, petitioner was an employee of Chesebrough-Pond's, Inc. ("Chesebrough"). On May 7, 1971 the petitioner purchased 140 shares of Chesebrough common stock from her employer for \$21.20 per share, or \$2,968. The purchase was made pursuant to her employer's Plan, which provided inter alia that "...all sales of shares under the Plan shall be made upon the condition that the purchaser shall continue in the ownership of such shares and not sell, pledge or transfer any interest therein for a period of five years after the date of acceptance of the purchase agreement by the Company." (11a, 21a, 26a-27a)

The petitioner's purchase of the shares from her employer was made pursuant to an Agreement which provided that if the petitioner left the employ of Chesebrough within one year after the date of the Agreement, Chesebrough had the option to cancel the Agreement and repurchase the shares for the amount paid by the petitioner. On May 7, 1972 her shares were no longer subject to forfeiture, but remained subject to a restriction that she not assign the

Agreement nor sell, pledge or transfer any interest in the shares for a period of four years. (26a-27a, 55a)

Pursuant to Section 83, the taxable event of the petitioner's bargain purchase took place on May 7, 1972 when her shares were no longer subject to a "substantial risk of forfeiture".

On May 5, 1972 (the last business day prior to Sunday, May 7, 1972), Chesebrough's common stock traded on the New York Stock Exchange at a mean quoted price of \$66.50. The respondent included in petitioner's income the entire excess of the \$66.50 New York Stock Exchange price over her \$21.20 cost per share or \$6,342 for the 140 shares. Respondent agrees that if freely-traded shares on the New York Stock Exchange were quoted on the valuation date at \$66.50 per share, petitioner's shares, subject to a four-year restriction against sale, transfer or pledge, were worth significantly less.^{2/} However, under the Internal Revenue Code (Section 83(a)) such a four-year restriction is disregarded for purposes of determining petitioner's gross income.

^{2/} See Rev. Rul. 68-86, 1968-1 C.B. 184. The issue of valuation of the restricted shares was separated for trial from the constitutional issue by Tax Court order, pending final resolution of the constitutional issue.

SUMMARY OF ARGUMENT

The ground for this appeal from the Tax Court's holding as to the constitutionality of Section 83(a) is that the court erred in upholding an income tax statute which measures income derived on an employee's bargain purchase of property, without regard to contractual restrictions on the transfer of that property, which significantly affect its value.

The constitutional measure of gross income resulting from an employee's bargain purchase of property is the actual fair market value of the property at the time the income is realized. Section 83(a) violates the due process clause of the Fifth Amendment to the extent it imposes a conclusive presumption as to the fair market value of property, which operates to deny the petitioner an opportunity to prove the actual fair market value of that property. Section 83(a) is unconstitutional under the Fifth and Sixteenth Amendments to the extent it imposes an income tax on an amount (determined without reference to the fair market value of the property received) which has no economic benefit to the petitioner.

ARGUMENT

I

SECTION 83 OF THE CODE IS A SIGNIFICANT DEPARTURE FROM THE BASIC CONCEPT OF INCOME TAXATION THAT THE MEASURE OF AN EMPLOYEE'S INCOME ON A BARGAIN PURCHASE OF PROPERTY CANNOT EXCEED THE ACTUAL FAIR MARKET VALUE OF SUCH PROPERTY

Petitioner appeals from the holding of the Tax Court that Section 83(a) of the Internal Revenue Code^{3/}

3/ I.R.C. §83(a) provides:

PROPERTY TRANSFERRED IN CONNECTION WITH PERFORMANCE OF SERVICES.

(a) GENERAL RULE. -- If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of --

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property,

shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture (emphasis added).

is constitutional, even though that section requires petitioner to pay income tax on value not received, based on a legislatively mandated valuation of property which significantly exceeds the actual fair market value of the property. The Tax Court so held, despite the fact that petitioner's shares on the date of the taxable event were subject to a restriction having a significant effect on value and were, therefore, worth significantly less than freely traded shares on the New York Stock Exchange on that date. No court has ever held that income realized from the receipt of property can, as a constitutional matter, exceed the fair market value of that property.

Until the passage of Section 83 in 1969, all judicial and regulatory authority consistently provided that an employee's income on a bargain purchase of property from his employer is measured by the actual fair market

value of that property.^{4/}

The Treasury Department first proposed detailed regulations on employee bargain purchases in 1956 which were finally adopted in 1959 as sections 1.61-2(d) and 1.421-6.^{5/}

^{4/} The Treasury Department in its first pronouncement on bargain purchases of stock in 1923 stated that, where property is sold by an employer to an employee for an amount less than its fair market value, the difference must be included in the employee's gross income. Treas. Dec. 3485, II-1 C.B. 50 (1923); see Treas. Reg. 65, Art. 31, §213(a) (1924). In deference to the Tax Court's "propriety interest" test (as expressed in Delbert G. Geeseman, 38 B.T.A. 258 (1938)) the regulations were amended to require the spread between fair market value and cost to be included in income only to the extent that the spread was in the nature of compensation. Treas. Reg. 111, §29.22(a)-1 (1943). The issue was reexamined after the Supreme Court's decision in Commissioner v. Smith, 324 U.S. 117 (1945) and the regulations were again amended in 1946 to state affirmatively that the excess of the fair market value over cost was in the nature of compensation, and, therefore, includable in gross income. Treas. Reg. 111, §29.22(a)-1 (1946). The Supreme Court in Commissioner v. LoBue, 351 U.S. 243 (1956) reached the same conclusion as the 1946 Treasury regulations, but specifically stated that it did not rely on the regulations. 351 U.S. at 249. The question of the amount of the fair market value of stock, taking into account various restrictions on sale, was also being considered by the courts at this time. See e.g. Victorson v. Commissioner, 326 F.2d 264 (2d Cir. 1964); MacDonald v. Commissioner, 230 F.2d 534 (7th Cir. 1956) and 248 F.2d 552 (7th Cir. 1957); Phil Kalech, 23 T.C. 672 (1955) (where the Commissioner successfully argued for a lower value because of restrictions on sale); Harold H. Kuchman, 18 T.C. 154 (1952); see also Commissioner v. Estate of Ogsbury, 258 F.2d 294 (2d Cir. 1958).

^{5/} Section 1.421-6 of the regulations, when first proposed, provided that if property is transferred subject to restrictions which substantially affect its value, the employee realized compensation at the time such restrictions lapse and the amount of compensation is the excess of the fair market value of the property at such time over the amount paid for the property. 21 Fed. Reg. 8774 (1956).

With respect to bargain purchases of stock subject to a "restriction having a significant effect on value", sections 1.61-2(d)(5) and 1.421-6(d)(2) of the regulations generally provided that (1) an employee does not realize compensation income until such restriction lapses, and (2) the amount of the income realized is the excess of (a) the lesser of the fair market value of stock (i) at the time of its acquisition or (ii) at the time the restriction lapses over (b) the amount paid for the stock. A contractual restriction, such as present in this case, which prevents the sale, assignment or pledge of shares for a specific number of years without the consent of the employer was ruled by the respondent to be a restriction having "a significant effect on the value of the stock."^{6/}

In 1968 regulations were proposed to change the measure of gross income.^{7/} Under the proposed regulations, the lapse of restrictions continued to be the taxable event, but the measure of gross income was to be determined solely by the fair market value at the date of the lapse.

Apparently the Treasury Department did not feel that the proposed regulations went far enough and in 1969, at the Treasury's behest, Congress enacted Section 321(a)

^{6/} Rev. Rul. 68-86, 1968-1 C.B. 184.

^{7/} Proposed Treas. Reg. §§1.61-2(d)(5) and 1.421-6 (d)(2), 33 Fed. Reg. 15870 (Oct. 26, 1968).

of the Tax Reform Act of 1969, which added Section 83 to the Internal Revenue Code. Section 83 is an addition to that part of the Code which enumerates the items specifically includable in gross income. Section 83(a) establishes the general rule which, by its terms, is to be applied whenever property (not subject to a substantial risk of forfeiture) is transferred to any person in connection with the performance of services: Gross income shall include the amount by which (1) the fair market value of such property (determined without regard to any restrictions other than a restriction which by its terms will never lapse) exceeds (2) the amount (if any) paid for such property. The only rationale for this legislation, as expressed by the Treasury Department,^{8/} was that it would conform the method of taxation under restricted stock plans to the method then provided in

^{8/} Hearings on the Subject of Tax Reform before the House Committee on Ways and Means, 91st Cong., 1st Sess. 5498 (1969) and testimony of Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy.

Section 402(b) of the Code.^{9/}

Congress thus departed in two significant ways from prior law, in the taxation of bargain purchases of non-forfeitable restricted stock: (1) the taxable event became the purchase itself, rather than the lapse of restrictions; and (2) the measure of income became something other than the actual fair market value of the restricted stock. The petitioner does not contend that Congress could not make the first change and thereby eliminate deferral of income under the regulations - thus taxing the recipient at the time the non-forfeitable property is received. However, Congress, by the second change, enacted a statute which mandates a fictitious valuation to determine an employee's

9/ Section 402(b) provided that an employer's contributions to a non-qualified pension or profit-sharing trust would be included in the employee's gross income at the time the contribution was made, provided that the employee's "beneficial interest in such contribution was non-forfeitable at the time the contribution is made." The analogy to Section 402(b) was appropriate with respect to the timing of income realization, but not to the measure of income. It is interesting to note that the Treasury relied on Section 402(b) to support its position that the value of non-forfeitable restricted stock would be included in the employee's gross income at the time of receipt. Section 402(b) was then amended in 1969 to incorporate the valuation rule of Section 83. Section 402(b) now provides that employer contributions after August 1, 1969 are included in the gross income of the employee under the rules of Section 83, but in applying those rules the words "the value of the employee's interest in the trust" are substituted for the words "fair market value of such property" in Section 83(a)(1).

income -- something it could not do and meet the standards of the Constitution.

Section 83(a) is a significant departure from a basic concept of income taxation - that income cannot exceed value received - a concept that has been followed by the courts and the Treasury Department for over fifty years. Congress cannot ignore this basic concept and constitutionally compel a taxpayer to pay an income tax based on the receipt of property valued in excess of its actual fair market value.

The Tax Court did not dispute that income realized from the receipt of property cannot, as a constitutional matter, exceed its fair market value. However, in the Tax Court's view (69a), "petitioner herein is merely charged in advance with an incremental value which in some sense is inherent in the property...." The difference between the restricted and unrestricted value (the so-called "incremental value") represents the increased investment risk to the petitioner who was not able to convert her property which fluctuates in value, into cash or other property for four years. This difference would not accrue to the petitioner over the four-year period like interest on a debt obligation issued at a discount. Rather, the petitioner would only be able to realize the economic benefit attributable to the

lapse of such restriction, if at the end of the four-year period the stock had not declined in value. To justify Section 83(a)'s fictitious valuation on the ground that the petitioner is merely being charged in advance with receipt of the incremental value "built-in" to the stock is to ignore completely the fluctuating nature of the value of the Chesebrough stock and the possibility that any value may ever be realized.

The constitutional defect of measuring petitioner's income on a bargain purchase of property by an amount in excess of the fair market value of the property cannot be justified by the Tax Court's irrelevant speculations that such amount was (69a-70a) "in all probability the real measure of the compensation intended by the parties...and presumably petitioner was aware of the measure of the compensation."

II

SECTION 83(a) IS UNCONSTITUTIONAL
TO THE EXTENT IT REQUIRES PETITIONER
TO PAY INCOME TAX BASED ON A LEGIS-
LATIVELY MANDATED VALUATION OF
PROPERTY WHICH ARBITRARILY EXCEEDS
THE ACTUAL FAIR MARKET VALUE OF THE
PROPERTY RECEIVED

Congress has the power under the Constitution "To lay and collect Taxes."^{10/} This power is limited, with

^{10/} U.S. CONST. art. I, §8, cl. 1.

respect to direct taxes, to taxes apportioned among the states on the basis of population.^{11/} An exception to the apportionment limitation on the laying of direct taxes is provided by the Sixteenth Amendment, which grants Congress the power "to lay and collect Taxes on income from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration." The constitutional grant of Congressional power to impose taxes is limited by the Fifth Amendment that no person shall "...be deprived of ...property, without due process of law."

Congress departed from judicial and regulatory adherence to these provisions of the Constitution when it enacted Section 83(a). To the extent Section 83(a) taxes the petitioner on a fictitious amount represented by the excess of the value of the stock without restrictions over the actual fair market value of the stock with the restrictions, it is unconstitutional because it (a) violates the due process clause of the Fifth Amendment, and (b) imposes a direct tax without apportionment on something which does not constitute income in violation of the Sixteenth Amendment.

^{11/} U.S. CONST. art. I, §2, cl. 3 and §9, cl. 4.

A. Section 83(a) as Applied to Petitioner
is Unconstitutional under the Fifth
Amendment

The Supreme Court has long recognized that the due process clause of the Fifth Amendment is applicable to Federal tax statutes.^{12/} Deprivation of property under the due process clause may take place through estate^{13/} or income^{14/} taxation.

In Schlesinger v. Wisconsin, 270 U.S. 230 (1926), petitioner challenged a Wisconsin statute that every gift of a material part of a decedent's estate made by him within six years of death "shall be construed to have been made in contemplation of death" (270 U.S. at 236) for death tax purposes. The Supreme Court held that the statute established an invalid conclusive presumption and declared it to be in violation of due process and equal protection. In Heiner v. Donnan, 285 U.S. 312 (1932) the Court considered a challenge to the constitutionality of a similar federal estate tax statute (Section 302(c) of the Revenue Act of 1926) providing that gifts made within two years of death

^{12/} Steward Machine Co. v. Davis, 301 U.S. 548 (1937); Heiner v. Donnan, 285 U.S. 312 (1932).

^{13/} Heiner v. Donnan, *supra*; Schlesinger v. Wisconsin, 270 U.S. 230 (1926).

^{14/} Hoeper v. Tax Commission, 284 U.S. 206 (1931).

of the donor shall "be deemed and held to have been made in contemplation of death" (285 U.S. at 320). In ruling the statute unconstitutional the Court held that the conclusive presumption established by the statute "constitutes an attempt by legislative fiat to enact into existence a fact which here does not, and cannot be made to exist in actuality" (285 U.S. at 329).

The tax statutes involved in Donnan and Schlesinger made relevant the fact of motivation for a gift and then foreclosed the taking of evidence of that fact. Likewise, Section 83(a) of the Code makes fair market value of the restricted property relevant and then precludes evidence on the effect of a contractual restriction on fair market value even when that restriction substantially affects fair market value. The constitutional principle which underlies the decisions in both Donnan and Schlesinger and is applicable here is "...that a statute which imposes a tax upon an assumption of fact which the taxpayer is forbidden to controvert is so arbitrary and unreasonable that it cannot stand under the..." due process clauses of the Fifth and Fourteenth Amendments to the Constitution.^{15/} The Supreme Court has stated that it "has held more than once that a statute creating a presumption which operates to deny a fair opportunity to rebut it violates the due process clause...."^{16/}

^{15/} Heiner v. Donnan, 285 U.S. at 325.

^{16/} Id. at 329.

In Hoeper v. Tax Commission, 284 U.S. 206 (1931), a Wisconsin statute measured a husband's income with reference to his wife's income for state income tax purposes. Under Wisconsin law a married woman's earnings were her separate property. The Supreme Court stated "that which is not in fact the taxpayer's income cannot be made such by calling it income" (284 U.S. at 215). Similarly, in Heiner v. Doi an, the Supreme Court held that the due process clause of the Fifth Amendment is violated when a statute puts upon a taxpayer "...the burden of tax measured in part by the value of property never owned by him" (285 U.S. at 328). In violation of these principles Congress has by Section 83(a) created income by measuring fair market value without reference to restrictions which substantially affect that value.

Mr. Justice Cardozo, in Burnet v. Wells, 289 U.S. 670 (1933) expressed the test whereby a Federal income tax statute was to be measured against the Fifth Amendment due process standard in the following words (289 U.S. at 679):

To overcome [the] statute the taxpayer must show that in attributing to him the ownership of the income ... or something fairly to be dealt with as equivalent to ownership, the lawmakers have done a wholly arbitrary thing, have found equivalence where there was none nor anything approaching it, and laid a burden unrelated to privilege or benefit.

Under Section 83 the petitioner has the burden of a tax on an amount which is not an economic benefit to her. In measuring her income the fair market value of the petitioner's stock subject to a four-year restriction against sale, transfer or pledge cannot be equated with the value of freely-traded shares on the New York Stock Exchange. Petitioner's income realized on the receipt of stock subject to a restriction which has a significant effect on value is not equal to the income that would have been realized if the stock were unrestricted.^{17/} Congress has done a "wholly arbitrary thing" in finding such "equivalence where there was none" and laying a tax "burden unrelated to [the] privilege or benefit" of the petitioner's receipt of stock.^{18/}

^{17/} H. Rep. No. 91-413 (Part 2), 91st Cong., 1st Sess. 62 (1969) on this point states:

[U]nder new subsection (a) even if property transferred is subject to a restriction which has a significant effect on value, if the beneficial interest is not subject to a substantial risk of forfeiture, the amount attributable to such transfer shall be included in gross income for the taxable year in which such beneficial interest is transferred....Thus, for example, assume that an employee purchases stock which has a fair market value of \$300 (determined without regard to the restriction) from his employer for \$100, and that the stock is subject to the sole restriction that it may not be sold for 5 years. Since there is no substantial risk of forfeiture, \$200 (\$300 - \$100) is included in gross income under subsection (a) for the taxable year of the purchase (emphasis added).

^{18/} Burnet v. Wells, 289 U.S. at 679.

The Tax Court does not disagree that petitioner's shares on the date of the taxable event were subject to a restriction having a significant effect on value and were, therefore, worth significantly less than freely traded shares on the New York Stock Exchange that date. The Tax Court never discusses whether income realized from the receipt of property can, as a constitutional matter, exceed its fair market value. Rather, in the Tax Court's view, the constitutionality of Section 83(a) turns on (1) the presumption of constitutionality, (2) its legislative purpose, (3) its administrative convenience, and (4) the relationship between its legislative classification and legislative purpose.

The Tax Court emphasizes that federal laws are presumed to be constitutional (59a, 72a). But such a presumption requires no restraint on the judicial duty to declare a statute invalid when it is contrary to the Constitution.^{19/}

Petitioner does not challenge the Congressional judgment that a method of income tax avoidance could be eliminated by discouraging the use of restricted stock plans. (60a-64a, 70a-71a) Petitioner acknowledges that current taxation of the actual economic benefit of her bargain purchase is a valid means of accomplishing that legislative purpose, even though petitioner could not

^{19/} Nicol v. Ames, 173 U.S. 509 (1899).

convert her economic benefit into cash for four years. But the Constitution is violated where the means also requires that a restriction which has a significant effect on value be ignored, with the result that petitioner has to pay income taxes in respect of value never received.^{20/} A legitimate legislative interest cannot be accomplished by unconstitutional means.^{21/} In holding unconstitutional a tax statute, which provided for a conclusive presumption that all inter vivos transfers were made within two years of death were in contemplation of death, the Supreme Court, in Heiner v. Donnan, said (285 U.S. at 328):

To sustain the validity of this irrebuttable presumption, it is argued, with apparent conviction, that under the prima facie presumption originally in force there had been a loss of revenue, and decisions holding that particular gifts were not made in contemplation of death are cited. This is very near to saying that an individual, innocent of evasion, may be stripped of his constitutional rights in order to further a more thorough enforcement of the tax against the guilty, a new and startling doctrine, condemned by its mere statement, and distinctly repudiated by this court in the Schlesinger and Hoeper Cases involving similar situations. Both emphatically declared that such rights were superior to this supposed necessity.

^{20/} It should be noted that "disparity" referred to in S. Rept. No. 91-552, 91 Cong., 1st Sess. (1969), (1969-3 C.B. 500), quoted in the Tax Court Opinion (63a) related only to the timing of income and not its measurement. Prior to the enactment of Section 83 if an employer contributed non-forfeitable, restricted property to a non-qualified pension or profit-sharing trust, the employee's income would be measured by the actual fair market value of the property with reference to restrictions. See footnote 9, supra, p. 11.

^{21/} Vlandis v. Kline, 412 U.S. 441 (1973); Helvering v. City Bank Farmers Trust Co., 296 U.S. 85 (1935).

Petitioner's income can be measured only by the actual fair market value of the property at the time of the taxable event, and, to the extent Section 83(a) inflates that income by ignoring a restriction which has a significant effect on value, the statute is unconstitutional regardless of the legitimacy of the statute's purpose.

Nor is the Tax Court's reliance on the administrative convenience of eliminating valuation problems (71a) support for the validity of the statute. Administrative convenience is no justification under the Constitution for precluding the petitioner from proving the correct amount of her income from the bargain purchase of property, subject to a restriction having a significant effect on value. The Supreme Court noted in Stanley v. Illinois, 404 U.S. 645 (1972) involving Illinois' irrebuttable statutory presumption declaring all unmarried fathers unqualified to raise their children, that Illinois (404 U.S. at 858) "insists on presuming rather than proving Stanley's unfitness solely because it is more convenient to presume than to prove. Under the Due Process Clause that advantage is insufficient

to justify refusing... a hearing...."^{22/}

The Tax Court believed (68a) that Donnan and Schlesinger and a number of recent Supreme Court cases (Cleveland Bd. of Educ. v. La Fleur, 414 U.S. 632 (1974); Vlandis v. Kline, 412 U.S. 441 (1973); U.S. Dep't of Agriculture v. Murry, 413 U.S. 508 (1973)) which followed their analysis, may not be current precedent in view of Justice Rehnquist's dissent in Vlandis and his majority opinion in Weinberger v. Salfi, 442 U.S. 749 (1975). The Seventh Circuit in Miller v. Carter, 547 F.2d 1314 (1977) recently noted that (547 F.2d at 1318) "...we cannot say that the [conclusive presumption] doctrine has lost the support of a majority of the Court because it has been invoked subsequent to Salfi..."

^{22/} The Supreme Court stated in Stanley (p. 656):

"[It] may be argued that unmarried fathers are so seldom fit that Illinois need not undergo the administrative inconvenience of inquiry in any case, including Stanley's. The establishment of prompt efficacious procedures to achieve legitimate state ends is a proper state interest worthy of cognizance in constitutional adjudication. But the Constitution recognizes higher values than speed and efficiency. [Footnote omitted.] Indeed, one might fairly say of the Bill of Rights in general, and the Due Process Clause in particular, that they were designed to protect the fragile values of a vulnerable citizenry from the overbearing concern for efficiency and efficacy that may characterize praiseworthy government officials no less, and perhaps more, than mediocre ones."

See also Cleveland Bd. of Educ. v. LaFleur, 414 U.S. 632 (1974); U.S. Dep't of Agriculture v. Murry, 413 U.S. 508 (1973).

In Salfi, the Supreme Court rejected a challenge to Section 416 of the Social Security Act which limits eligibility for benefits to persons whose relationship with the insured began at least nine months before his death. The District Court held that the duration of relationship requirement was intended by Congress to prevent use of sham marriages to secure Social Security payments and since the statute foreclosed proof on the purpose of the marriage, the statute was struck down because it presumed a fact which was not necessarily or universally true. The Court stated that it had previously held in Flemming v. Nestor, 363 U.S. 603 (1960) and Richardson v. Belcher, 404 U.S. 78 (1971) that in dealing with non-contractual benefits under a social welfare program a different standard of constitutional review is appropriate. Therefore, due process is only violated under a social welfare program such as Social Security where there is no rational relationship between the legislative classification and the legislative purpose under the Salfi and Belcher decisions.

The Tax Court erroneously applied this standard to an income tax statute that creates income by means of an irrebuttable presumption that adds a fictitious amount to fair market value. Petitioner does not claim that all statutory conclusive presumptions are per se unconstitutional.

However, over fifty years ago the Supreme Court struck down three tax statutes that contained inaccurate conclusive presumptions in Schlesinger, Donnan and Hoeper. More recently, statutes, which conclusively presumed that unmarried fathers were unqualified to raise their children,^{23/} or that non-resident college applicants were non-resident students,^{24/} or that teachers in fifth or sixth months of pregnancy were too disabled to teach,^{25/} were held to violate due process, because the presumption was "neither necessarily [nor] universally true."^{26/} The conclusive presumption in Section 83(a) is never true - the fair market

^{23/} Stanley v. Illinois, 405 U.S. 658.

^{24/} Vlandis v. Kline, 412 U.S. 441 (1973).

^{25/} Cleveland Bd. of Educ. v. LaFleur, 414 U.S. 632 (1974).

^{26/} Cleveland Bd. of Educ. v. LaFleur, 414 U.S. at 646-47, citing Vlandis v. Kline, 412 U.S. at 452, where the Supreme Court stated:

"Since [the Connecticut statute, which provided a presumption that is not necessarily or universally true in fact,] precluded the appellees from ever rebutting the presumption that they were non-residents of Connecticut, that statute operated to deprive them of a significant amount of their money without due process of law."

value of property subject to a restriction having a significant effect on value cannot equal the fair market value of the same property without restrictions. Constitutionally, Congress should not have decided that fair market value is determined without regard to restrictions which have a significant effect on value.^{27/} Congress cannot "...by legislative fiat...enact into existence a fact which...does not and cannot be made to exist, in actuality...."^{28/}

B. Section 83(a) as Applied to Petitioner is Unconstitutional under the Sixteenth Amendment.

Section 83's disregard of a restriction having a significant effect on value in defining income is also vulnerable under the Sixteenth Amendment. The United States Supreme Court in Eisner v. Macomber, 252 U.S. 189 (1920) held that, by virtue of the Sixteenth Amendment, Congress had no power to tax stock dividends as income without apportionment. The Court stated that the Sixteenth Amendment did not itself define "income", but that the term had a

^{27/} Congress intended the Section 83(a) valuation rule to be operative even if the restriction substantially affected fair market value. H.Rep.No. 91-413 (Part 2), 91st Cong., 1st Sess. 62 (1969). The respondent has ruled that restrictions, substantially identical to those which petitioner's stock was subject, have a significant effect on value. Rev. Rul. 68-86, 1968-1 C.B. 184.

^{28/} Heiner v. Donnan, 285 U.S. at 329.

well-defined meaning at the time the Amendment was adopted in 1913. In describing the Sixteenth Amendment the Court said (252 U.S. at 206):

A proper regard for its genesis, as well as its very clear language, requires also that [the Sixteenth] Amendment shall not be extended by loose construction....Congress cannot by any definition [of income] it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.

The majority and minority opinions in Eisner v. Macomber differed on the precise definition of income, but not in the acknowledgment that an amount must be an economic benefit in order to be taxed as "income" under the Sixteenth Amendment.

The Supreme Court later stated in Helvering v. Stuart, 317 U.S. 154, 168 (1942) that "economic gain realized or realizable by the taxpayer is necessary to produce a taxable income."

In Section 83, Congress, by ignoring for income tax purposes restrictions which have a significant effect on value, has imposed a tax on an amount which is not an economic gain or benefit and is therefore not income. Congress cannot, consistently with the Sixteenth Amendment, disregard a restriction which has a significant effect on value in determining the income realized by the petitioner. The Constitution prohibits Congress from compelling the

petitioner to pay an income tax based on a valuation of property in excess of the actual value of the property received.

The Tax Court dismisses petitioner's Sixteenth Amendment argument by referring to the broad Congressional power to define "income" and stating that "taxation despite nonreceipt is common and the actual reduction to possession is not a constitutional requirement". (65a)

Petitioner recognizes the broad power of Congress to define income but maintains there is no constitutional authority for labelling an amount "income" for tax purposes when that amount is in excess of the actual economic benefit to the person charged with that "income". Clearly taxing the unrestricted fair market value of restricted property is to tax something more than income. Congress may label this amount "income" in Section 83(a) but as the Supreme Court said in Hoeper (284 U.S. at 215), "That which is not in fact the taxpayer's income cannot be made such by calling it income".^{29/}

^{29/} Mr. Justice Brandeis stated in Burk-Waggoner Oil Ass'n v. Hopkins, 269 U.S. 110, 114 (1925) that "Congress cannot make a thing income which is not so in fact" to come within the Sixteenth Amendment's exception to the apportionment limitation of the Constitution.

The petitioner does not complain that her constitutional rights are being violated because she is being taxed even though she has not actually received or "possessed" her economic benefit. But her rights are violated since the amount in issue is clearly not an economic benefit to her and she is being taxed as if it were. Congress is without the power to lay an unapportioned direct tax against the property received by petitioner. The Sixteenth Amendment is no exception to the apportionment limitation of the Constitution to the extent such property is not income to petitioner.

CONCLUSION

The Tax Court erred in failing to hold that Section 83(a) is unconstitutional to the extent it compels petitioner to pay income tax based upon the receipt of property in excess of its fair market value on the date of the taxable event. The Tax Court should be directed to hear evidence as to the actual fair market value of petitioner's 140 restricted Chesebrough shares on May 7, 1972.

Respectfully submitted,

BURTON G. LIPSKY
Counsel for Petitioner-Appellant

Of Counsel:
DELSON & GORDON

September, 1977

**COURT OF APPEALS
SECOND CIRCUIT**

MIRIAM SAKOL,
Petitioner-Appellant,

- against -

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Index No.

Affidavit of Service by Mail

STATE OF NEW YORK, COUNTY OF NEW YORK ss.:

I, Robert L. Martinez, being duly sworn, depose and say that deponent is not a party to the action, is over 18 years of age and resides at 1165 Morris Avenue; Bronx, New York; 10456
That on the 28th day of Sept. 19 77 deponent served the annexed

Appendix

Brief upon

M. Carr Ferguson

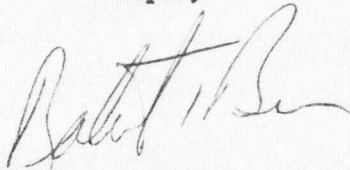
Asst. Attorney General

in this action, at Washington D. C.

attorney(s) for

the address designated by said attorney(s) for that purpose by depositing a true copy of same, enclosed in a postpaid properly addressed wrapper in a Post Office Official Depository under the exclusive care and custody of the United States Post Office Department, within the State of New York.

Sworn to before me, this 28th
day of Sept., 1977



ROBERT T. BRIN
NOTARY PUBLIC, State of New York
No. 31-0418950
Qualified in New York County
Commission Expires March 30, 1979


Robert L. Martinez

